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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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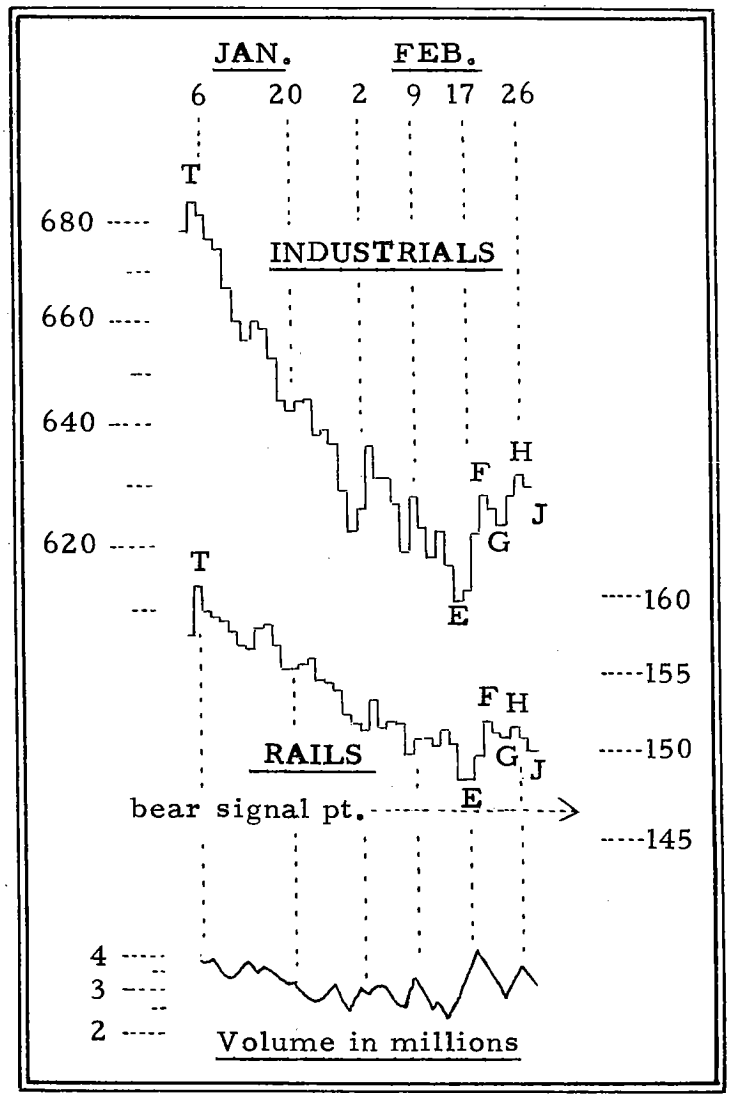
THE MARKET. Since the recent lows at E (see chart -- Industrials 611.33, Rails 148.37) a very unusual picture has evolved. Industrials have formed a definite upward zig-zag (E-F-G-H) while Rails on Friday, February 26, closed 1¢ under their minor point at G to form a downward zig-zag (F-G-H-J). On Monday, February 29, both Averages sank lower so that the descending zig-zag in the Rail Average was even more apparent. Although volume decreased on February 29, it was interesting to note that Rails dropped .60% on the day as compared to .30% in Industrials or twice as fast.

In Letter 94 I wrote that Rails, having stubbornly resisted breaking their primary bear point (146.65), would normally be expected to lead the way on the next rally, Rail weakness on a rally, I added, would be something to watch carefully, since such action might be the first hint of distribution in the carriers.

The current situation is this: if on any weakness, the Rails can hold above point E (148.37) and more important, of course, above their bear point at 146.65 (as volume diminishes), then there is a reasonable chance that the market is consolidating for an advance which will tend to correct at least 1/3 to 2/3 of the losses since T. If, on a decline, Rails violate their primary bear point at 146.65 the bear signal will have been given.



In view of the upward zig-zag in Industrials, the following alternatives present themselves: if, on a rally, Rails can better their preceding little peak at F (151.90) they will be confirming the Industrial strength. In this case a sharp and possibly extended rally might well be in the offing. Conversely, should Industrials now turn weak and violate their preceding minor decline point at G (623.73), they would be confirming the weakness in the Rail Average, and this would be distinctly bearish, particularly if volume picked up on such an Industrial penetration.

In the majority of cases, after a bull market reaction, a period of sidewise movement develops. The big picture, if we are now in a bull market, is as follows: If the Rails can continue to hold above 146.65 during a period of consolidation which might last anywhere from a few weeks to even months, there is a

reasonable chance that the upward trend will again be resumed. In this case, the technical indicators should gradually turn bullish. For instance, the short interest and short interest ratio should turn up, advance-declines ratios should work higher, odd-lots should show a trend towards less buying.

A warning -- sidewise movement alone will not signal a coming advance. Precedence must always be given to the eventual breakout of the Averages. There have been periods, such as late 1902, where a period of extended sidewise movement was terminated by downward penetrations. This precipitated a violent market collapse. If the two Averages work sideways now and the move finally ends with a downward Rail penetration through 146.65 the experience of 1902 might be repeated. It is only when the dragging sidewise movement is followed or formed by ascending zig-zags in both Averages that the implications are strongly in favor of a resumption of the bull market.

CONCLUSION. Under the "continuing trend" principle of the Dow Theory, the primary trend must be classified as bullish. It will continue bullish until or unless Rails violate their November low of 146.65. Because of the divergence, the secondary and minor trends are obscure. Volume has been deceptive for some time now, and I, personally, would not be tempted to buy in the present situation unless Rails better F (151.90) to the accompaniment of increasing volume. Presumably, this could result in paying slightly higher prices, but I would consider any such premiums as money well spent.

SHIPPING AND PRODUCTION. Behind the Dow Theory, the meaning of the price movements has a fundamental basis. Newspapers are now widely quoting statements to the effect that 1960 will not be a "roaring boom year", but it will be a "good workmanlike year." Industrial production, particularly in steel and automobiles, has already eased. If Rails violate 146.65 we can infer that industrial production will not only slide off, but that sales and transportation will also turn down. These are the seeds from which bear markets flower.

"LOST" PROFITS. From my observation, experienced investors are guided in their market action by the following principles: most important -- safety of capital; second -- return on capital; third -- possible long-term profits; last -- possible short-term profits. The public (particularly during extended bull markets) tends to hold the following views toward investing: most important -- any kind of a possible profit; second -- income from capital; last -- safety of capital. There is no question in my mind but that the experienced investors are correct and the public is wrong.

Many people are now so eager for stock market profits (perhaps the high cost of living "squeeze" is a factor) that they will readily gamble a few years' savings (after taxes, of course) on a stock they know nothing about in a market which is uncertain or trendless. The result is usually a loss.

A number of subscribers expressed surprise at last week's quote from Rhea, "When in doubt, do nothing." I can not seem to get across to these readers that safety of principle is always more important than possible speculative profits. Veteran traders will willingly pass up a move when they are uncertain of the market, but "fools and gamblers rush in where veterans fear to tread." No one can blame an investor for missing a possible profit in the stock market, but when a man continually takes losses through greed, impatience or pride of opinion he is hopeless, and he would be better off playing "Twenty-One" with his neighbor (there are no commissions, taxes and bid-and-asked differentials in the latter).

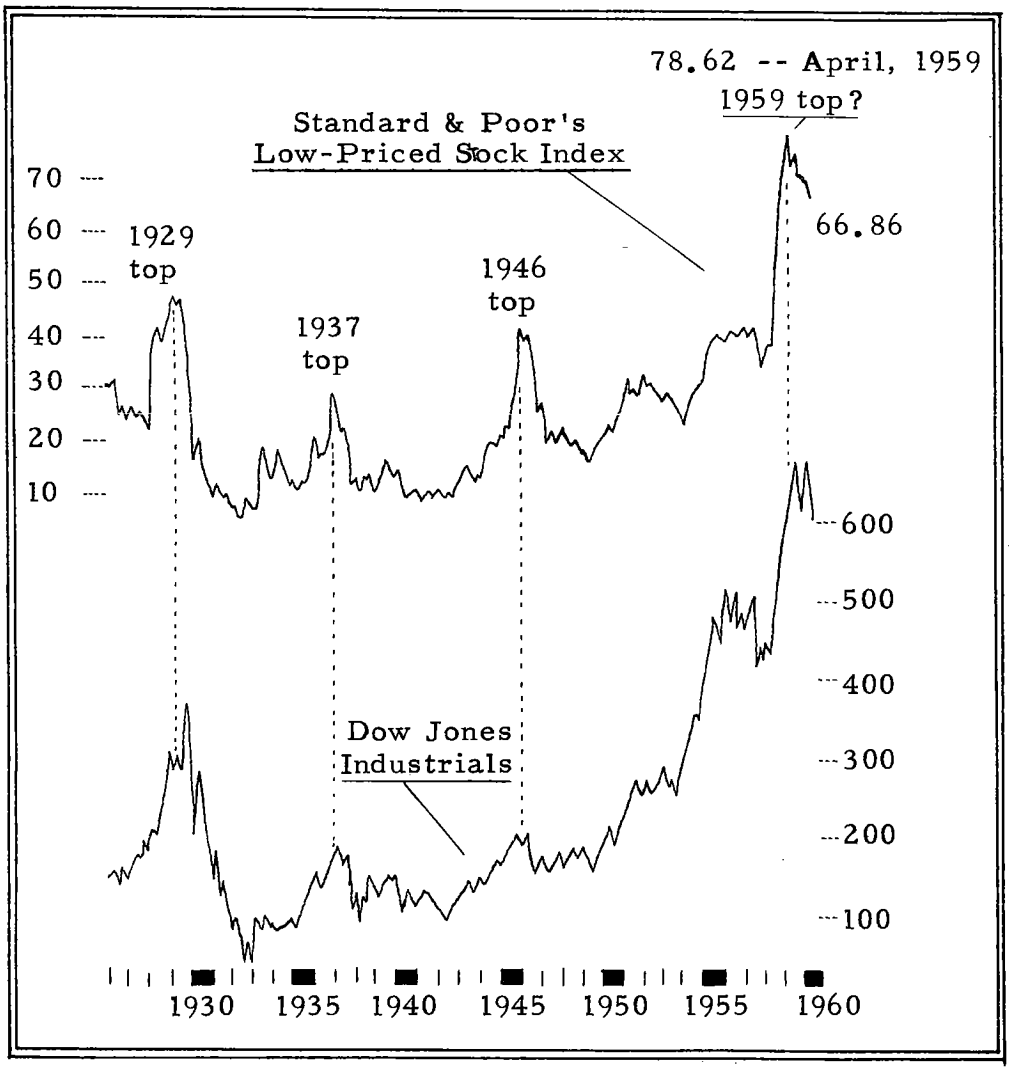
"If a trader has made a serious mistake in judging the market trend and, in so doing, has realized a substantial loss," wrote Rhea, "he should get out of the market entirely and stand on the side lines until he has recovered his poise." Again he observed, "The

intelligent speculator must not be compared to the board room pest who neglects his business because of his market dabbling. It is almost an axiom that the dabbler loses his money, while the intelligent speculator, if not successful, at least limits his losses to a sum which he can afford to lose." Personally, I never feel badly when I miss a profit which "might have been", for the market is always there, and each year has its extended swings.

LOW-PRICED STOCK MOVEMENTS. Periodically these Letters discuss the movements of the low-priced stocks. The study is based on a few simple premises: (1) history shows that the public will not participate wholeheartedly in a bull market until that bull market has reached its final (third) phase, (2) a large segment of the public does not care about "values"; they buy for a "play" or simply because "they said stocks were going up", (3) only an excited public will pay premium prices for the low-quality "cats-and-dogs". For the aforementioned reasons the pattern of the L-P Stock Index provides an excellent barometer of speculative sentiment and public participation. The accompanying chart compares the movements of Standard & Poor's Index of 20 Low-Priced Stocks with those of the high-grade D-J Industrials.

Note that towards the end of the 1921-29, 1932-37 and 1942-46 bull markets the L-P Index rose almost vertically; these violent advances occurred as each respective bull market entered its third phase. The dotted lines on the chart are drawn through the peak of each low-priced stock advance, and in each case this peak came a few months to almost a year ahead of the final peak in the D-J Industrials. It is also interesting to observe that the L-P Index tends to form a final "spear-point" top, and the descent from this top is usually as steep as was the preceding rise. The reason for this is that low-priced stocks seldom have institutional or investor support, which means that they are not carefully distributed at the highs. Low-priced stocks are generally sold haphazardly or "dumped", and this gives them sharp (often one-day) reversals.

In the present situation the L-P Index hit a high of 78.62 in April, 1959, fully eleven months ago, and that Index has not again approached its former peak (despite the recent January 5 high recorded by the D-J Industrials). Last week, in fact, S & P's L-P Index touched a new low since April, 1959. This suggests that the L-P Index may have topped. Judging by past precedent, it would be most unusual, following the 1959 spear-point peak, for the L-P Index to reverse its trend and go to a new high.

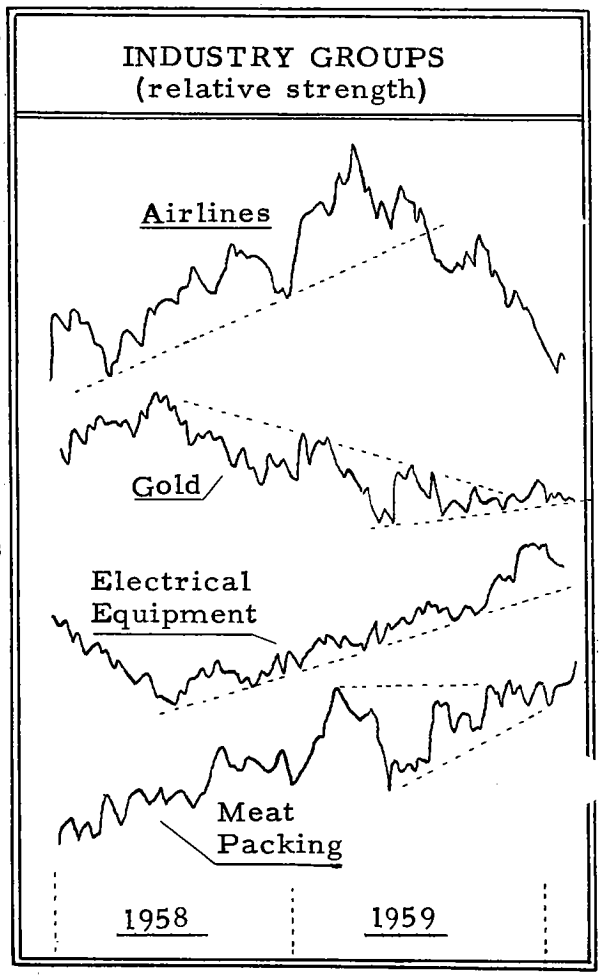


RELATIVE STRENGTH. In the past I have mentioned the value of relative strength as a guide to investing (in both individual stocks and industry groups). Rhea did some of the pioneer work in this field, and the principle is quite simple. If a stock or an industry group consistently out-performs the market both on rallies and declines, that trend will usually continue for a further (but indeterminate) period of time. The charts below are from studies sent to me each week from my friends at Traders Research, Inc., Room 4600, 70 Pine Street, N.Y.C. These charts show the movements of the various industry groups as compared to the broad Standard & Poor's Average of 500 stocks.

If the general market (as measured by S & P's 500 Average) is declining but an industry group is declining at a slower rate than the market, the relative strength line will move up. By the same token, if the market is advancing but the group is advancing faster than the market, the relative strength line will continue to move up. The exact converse is true of a group whose relative strength is weaker than the market. Group relative strength is particularly important, since often an excellent individual stock will be held back for no other reason than that its industry group is out of favor with investors.

On the chart I have pictured one of the worst industry groups and three of the best. Note the downturn in Airline strength in early 1959 and the continuing weakness in this group. Since we are interested in relative strength as a trend, drawing in trend-lines can be helpful in analyzing chart performance. The Gold group, for instance, after tending down from mid-1958 to early 1959, is now showing a gradually bettering performance. Electrical equipment has outperformed the market since mid-1958; that major trend has not yet been halted. Meat packing shows very strong relative strength, and after a brief period of weakness in early 1959 this group has just bettered its 1959 peak of strength.

In general, new purchases should be restricted to groups that are outperforming the market while weak groups should be eliminated or avoided. All of this can be coordinated with the Dow Theory. For instance, in a primary bear market we would not be tempted to buy a strong group, regardless of relative strength. The odds, in this case, would be in favor of our merely losing less money than otherwise, and the strong group would merely show fewer losses than the weaker groups. From time to time I will publish various relative strength group charts, and I believe they will be of value to readers.



CONTRARY OPINION? One thing which bothers me is the almost universally held opinion that the lows have been seen and that the selling is over. It is hard to remember a time when so many analysts and services "successfully" called the "turn". From the bulls' standpoint, things would look far healthier if, instead of all the talk of the February 17 "selling climax" and "intra-day reversal", one heard comments such as "you'll buy them cheaper in March" and "January was just the beginning".

NOTE. The Hamilton book ("The Stock Market Barometer") should be ready for mailing sometime toward the end of March. I wish to thank subscribers for their very gratifying response to last week's announcement.

(Written: March 1st, 2 P.M.)